RESPONDING TO ASIA'S CRISES*

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It is now more than a year since the financial crises broke out in East Asia. Yet the sharp currency depreciations associated with the crises have not spurred rapid growth in their dollar exports, which would underpin a rebound in economic activity in the region. What accounts for the sluggish recovery in East Asia? What are the appropriate policy responses? This article attempts to provide some perspective on these questions by reviewing the impact of East Asia's crises on their financial sectors. It argues that difficulties in restoring financial flows are the main obstacle to recovery in East Asia, and stresses the importance of adopting policies that will facilitate the participation of private investors in the recovery.

Crises and Effects

For decades, East Asia was widely regarded as a model for other emerging markets. Fiscal policy was not profligate, monetary policy was not inflationary, and the region enjoyed high saving and investment rates. What the crises in East Asia have taught economists and policymakers is that these "fundamentals" alone are not enough to insulate an economy from a crisis.

Rather, problems in other "fundamentals" made East Asian economies vulnerable. Starting in the second half of the 1980s, rapid growth was accompanied by sharp increases in stock and land prices. East Asians borrowed against their increased wealth, in some cases rapidly increasing short-term borrowing from abroad. The boom lasted until the mid-1990s, when a series of external shocks—greater competition from China, the depreciation of the Japanese yen, and the sharp decline in semiconductor prices—hurt East Asian export revenues, causing slower economic growth and falling asset prices. In some Asian economies, these events were accompanied by growing weakness in the financial sector that ultimately triggered collapsing currencies, starting with Thailand in July 1997. The events in Thailand prompted investors to reassess and test the robustness of currency pegs and financial systems in the region. The result was a wave of currency depreciations (20%-80%) and stock market declines (50% or higher), first affecting Southeast Asia, then spreading to the rest of the region (see Moreno 1998 for more detailed discussion of the causes of the Asian crises).

Other things equal, a currency depreciation would stimulate growth by lowering the price of exports. But in East Asia, other things have not been equal, so to speak. The currency devaluations and collapsing asset prices not only caused steep reductions in wealth and purchasing power, but they also disrupted the balance sheets of lenders and borrowers in East Asia. Many East Asian firms borrowed in U.S. dollars without hedging, and the large increases in their debt burdens when currency pegs collapsed have rendered them insolvent. The weak balance sheets of borrowers have in turn impaired the financial position of banks, producing a severe credit crunch that is a major obstacle to recovery, particularly in the three economies with the most fragile financial sectors—Indonesia, Korea and Thailand. Indeed, lack of access to financing is an important reason why East Asian exporters have been unable to increase their output. Combining this with the recession in Japan, one of their major export markets, set the stage for a severe economic contraction.

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Policy Responses

Observers agree that the key to overcoming East Asia's crises is to restore voluntary financial flows and investment spending. However, they disagree on the best way to achieve this. The strategy so far has been to stimulate investor confidence and spending by (i) stabilizing the external payments position of East Asian economies and (ii) restoring credit flows.

The external payments situation has been stabilized through large IMF-led aid programs (totaling $118 billion for the most affected East Asian economies), the rescheduling of short-term foreign debt, and reductions in foreign borrowing through painful reversals of current account deficits. For example, in South Korea, foreign reserves were nearly depleted at the end of 1997. Adjustment efforts strengthened the balance of payments position to such a degree that by the second quarter of 1998, the South Korean won began appreciating, to the discomfort of South Korean exporters. (A similar rebound in the exchange rate is apparent in Thailand.) Nevertheless, there are few signs of growth in South Korea because credit flows have stopped.

Restoring credit flows and investment requires repairing the balance sheets of banks and borrowers. Lenders are saddled with bad loans, and even those in a better financial position will not lend to firms whose net worth is negative, even if these firms have profitable projects. Bankrupt institutions need to be weeded out, non-performing loans have to be written off, and financial institutions and borrowers recapitalized so that normal operations can resume.

In a market economy, recapitalization happens automatically, as stronger and more efficient firms take over bankrupt institutions at low prices, setting the stage for renewed investment and recovery. However, East Asia faces a number of obstacles to such a market adjustment. In several countries, the lack of effective bankruptcy provisions has made it difficult to dispose of properties. The true value of assets being offered for sale is hard to determine, due to a lack of transparency and deficient accounting and reporting. In some cases, the high debt ratios of corporations make them unattractive buys. For example, earlier this year, Ford Motor Corporation withdrew its bid to purchase bankrupt Kia Motors in Korea because of Kia's extremely large debt. Investors also have been deterred by labor market conditions that make it very difficult to restructure firms.

While East Asian policymakers are working to overcome these obstacles, progress has been slow. One reason is that these characteristics of East Asian economies are part of institutional arrangements associated with decades of rapid growth. It is still not entirely clear whether the current crises have produced a consensus on the value of abandoning these arrangements.

As the costs of recapitalization after a major financial crisis are often very high (they have reached 25% of GDP or higher in major banking crises in other regions), government funds also are needed. In the short run, central bank funds have been used to assume bad loans and pay off depositors of failing institutions. In order to keep the central bank balance sheet healthy and limit money creation, the central government at some point assumes the costs directly through deficit financing or tax revenues. Financial sector repair thus raises questions about the extent to which policymakers should resort to money creation, raise taxes, or rely on deficit financing. This is closely related to the hotly debated question of the appropriate fiscal and monetary policy response to the crises.

Macroeconomic Policies

In dealing with the crises, East Asian policymakers face a policy dilemma, as they must simultaneously (i) stimulate the economy and (ii) stabilize the exchange rate as well as inflation, the latter being important to restore voluntary credit flows. (The double-digit inflation in Indonesia suggests that, in spite of economic contraction, the threat of inflation is real.) To resolve the dilemma Moreno, Pasadilla, and Remolona (1998) suggest that fiscal policy be assigned to restore growth (including financial sector repair and the social safety net) and monetary policy to stabilize exchange rate expectations and inflation. The latter implies maintaining a predictable monetary policy stance with some clear nominal target, given that exchange rate targeting is too costly. (For example, in Mexico after 1994, the monetary base was targeted, but some other target also may be considered.) However, the overall degree of tightness or ease in macroeconomic policy needs to be determined case by case.

Macroeconomic policies in East Asia were initially tight, but have since eased considerably. For example, anticipated 1998 fiscal deficits in the IMF program for Korea rose from 1% of GDP in February to 5% of GDP in the latest program. In Indonesia, an originally anticipated fiscal surplus of 1% of GDP switched to a deficit of 8.5%. As for interest rates, these rose in the early stages of the crises, when currencies were under pressure, but have since declined in a number of economies. For example, after reaching a peak of 35%, the Korean interbank rate at this writing had fallen to just over 8%, compared to around 14% when the crises broke out. Nominal interest rates in Indonesia are still high—close to 70%—but are much lower after accounting for inflation.

Have Current Policies Worked?

Have the strategies for overcoming the crises worked so far? It is now generally recognized that fiscal policy was too tight in the early stages of the crises, in part because growth forecasts were too optimistic. As occurred in Mexico after the peso collapse in 1994, many observers initially failed to recognize that the sudden reversal in capital inflows and related disruptions in the flow of credit would cause severe economic contraction.

While interest rates also have fallen to their pre-crisis levels, initially tight monetary policies have been criticized. But it is not clear whether calls for much more aggressive monetary stimulus should be heeded. With an open capital account, lowering interest rates can further destabilize the exchange rate, which will not restore investment confidence nor output growth.

To allow for greater monetary stimulus without destabilizing the exchange rate, some economists (Krugman 1998) have called for the imposition of capital controls, a step recently adopted by Malaysia. Under the new rules, central bank approval is needed to convert Malaysian ringgit into foreign exchange, and transactions involving foreign currency or foreign residents are generally restricted. (The government still permits (i) general convertibility of current account transactions, (ii) free flows of direct foreign investment, and (iii) repatriation of interest, profits, and dividends and capital.) This prevents the sudden outflow of capital even if Malaysian interest rates fall below world interest rates. The Malaysian ringgit has been fixed at 3.80 to the U.S. dollar, and the government has adopted a number of measures to stimulate credit.

This strategy reflects the perception that in the current uncertain global environment, investors (both domestic and foreign) whose capital has left emerging markets are not likely to bring these funds back in the near future. It thus relies on domestic macroeconomic stimulus, rather than the resumption of private financing, to restore economic activity. This strategy involves at least two risks.

First, the restoration of capital inflows may turn out to be crucial in ensuring an early recovery after all. Indeed, it can be argued that one reason Mexico recovered so quickly from the 1994 peso crisis is the large foreign investor participation in its export sector. These well-capitalized producers experienced no interruption in their access to credit. East Asian producers with viable plants, in contrast, are having great difficulty securing working capital or other financing because of the disruptions in their balance sheets. Capital controls may discourage foreign equity financing (or the repatriation of East Asian capital) that could help overcome this problem, thus delaying the recovery. Monetary stimulus may offset these effects, but the sluggish growth of Japan in the 1990s suggests that such stimulus may not easily overcome weaknesses in the financial sector.

Second, capital controls may insulate economies that adopt them so effectively that they will lose the incentive to restructure their economies in a manner that will help prevent future crises. Given the high costs of the current crises, this is an important consideration in choosing policy responses.

References

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